Teachers' Retirement Board
Investment Committee
Open Session

Subject:	**Alternative Investments- Role of Alternative Investments**	**Item Number:**	**4**
		Attachment(s):	**3**
Action:	**X**	**Date of Meeting:**	**May 6, 1998**
Information:		**Presenters:**	**Mr. Desrochers** **Mr. LeBon**

EXECUTIVE SUMMARY

One of the 1997-98 objectives approved for the Investment Branch was to review, evaluate, and revise the policies and procedures for the Alternative Investment Program. The first element is defining the primary role of alternative investments. After the role is established, the second element is revising the policies and procedures. The policies and procedures provide parameters that will ensure prudence and care in the management of the portfolio while allowing sufficient flexibility to control risk and capture investment opportunities.

Attachment 1 provides a review of the global investment alternative investment marketplace, characteristics of alternative investments, and an overview of STRS' alternative investment portfolio.

In Attachment 2, Pathway Capital Management analyzes various methods of investing in alternative investments and discusses expected trends in the alternative investment marketplace.

Attachment 3 contains policies and procedures to be used in the management of the alternative investment program. Policies are designed to be static in nature and will be returned to the Investment Committee prior to changes being implemented. Procedures describe the policy implementation process and must be dynamic in nature to facilitate the adaptation to the changing alternative investment marketplace.

RECOMMENDATIONS

1. Staff and Pathway Capital Management recommend that the primary role of alternative investments is to provide

enhanced returns over those available with public equity market investments.

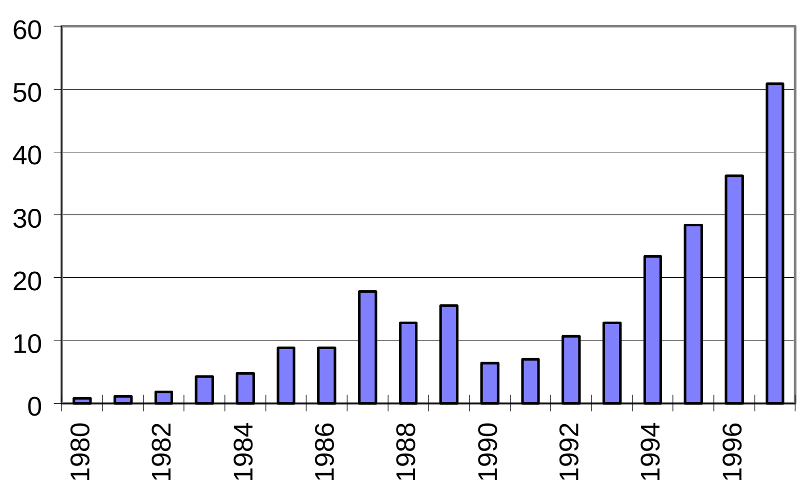
2. Staff and Pathway Capital Management recommend approval of the alternative investment policies and procedures manual.

THE ROLE OF ALTERNATIVE INVESTMENTS

BACKGROUND

The private equity market began to evolve in an organized fashion in the post-World War II period but remained a small, informal market until the late 1970s. For the first 30 years of its history, the marketplace was dominated by a handful of wealthy families, financial institutions, and industrial corporations. Pension fund investment in the private equity market did not become significant until the early 1980s. The dramatic growth of pension fund involvement in the private equity market can largely be traced to the 1978 Department of Labor (DOL) ruling pertaining to the "prudent man" rule governing pension fund investing, which stated that prudence would be determined by viewing the portfolio as a whole, rather than by the risk of each individual investment. This important clarification of ERISA, which had been passed in 1974, placed a very important emphasis on diversification in the private equity process and opened the doors for corporate pension plans to invest in private equity partnerships without violating their fiduciary responsibilities. The following chart indicates the growth that resulted in the asset class as pension funds became significantly involved.

Private Equity Partnership Fund-Raising
($ billions)



Source: Private Equity Analyst

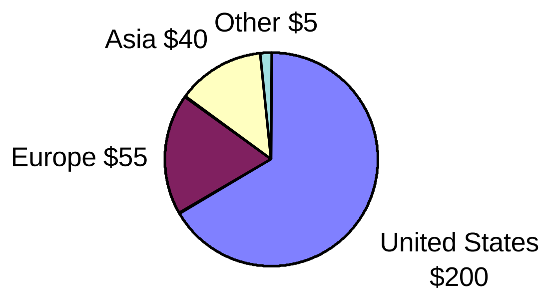
For purposes of simplicity, a private equity portfolio can be classified in subsets called venture capital and special equity. Venture capital partnerships focus on equity financings for early stage companies undergoing rapid growth, typically in the information technology, healthcare, retail services, and consumer products industries. The special equity category refers to partnerships that do not operate as typical venture partnerships, yet still employ private equity disciplines. These include buyout partnerships which focus primarily on change of control transactions targeting more established companies in mature industries, typically in the manufacturing and service segments of the economy. Other types of partnerships included in the special equity category include partnerships which focus on specific industries such as media and communications or energy, employ “hybrid” strategies, or invest in particular classes of securities such as subordinated debt. Other partnerships are simply opportunistic.

INVESTMENT ENVIRONMENT

The United States is the most diversified and mature private equity market in the world. The United Kingdom is the second most developed private equity market after the U.S. The rest of Continental Europe has developed slowly. Historically, privately-held European companies received funding from a combination of banks and other financial institutions, the government, private families, and industrial companies. The rest of the global private equity market is still in its infancy. The Asian market is expanding primarily due to funds focused on infrastructure or infrastructure-related investments. Elsewhere, Latin America and other emerging markets countries have more recently sparked the interest of American and international fund raisers, setting the stage for more rapid growth.

The cumulative amount of money subscribed to the global private equity market amounts to approximately $300 billion. This represents only 2% of the total assets of the world public markets (estimated at $12,462 billion as reported by MSCI EAFE and World Perspective, 12/97). As shown in the chart below, the U.S. private equity market represents two-thirds of global private equity commitments. The remaining one-third of the market is comprised of commitments to the European, Asian, and emerging markets countries such as Latin America.

Amount Committed to Global Private Equity
(In Billions)



Source: Asian Venture Capital Journal, Venture Economics, European Venture Capital Association (EVCA), Alternative Assets

CHARACTERISTICS OF PRIVATE EQUITY

As mentioned previously, STRS' private equity portfolio is classified into two categories called venture capital and special equity. These categories possess vastly different characteristics as illustrated below.

Venture Capital

- Fast growth, participate in dynamic industry segments that are either new or expanding rapidly.
- Typical industry sectors include information technology, healthcare, retail services, consumer products.
- Average transaction size $1 - $10 million
- Early stage: seed or start-up equity investments in private companies.
- Later stage: investments in more mature companies to provide funding for growth and expansion.
- Multi-stage: investments in companies at various stages of development.

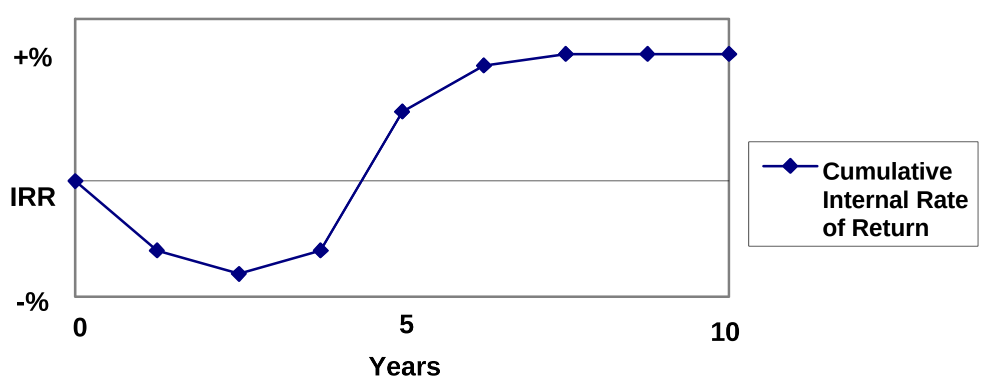
Special Equity

- Acquisitions: partnerships which provide funding to acquire a business or product line from either a private or public company.
- Restructuring and recovery: investments made in poorly performing companies with the intent of initiating a recovery via financial and management re-engineering.

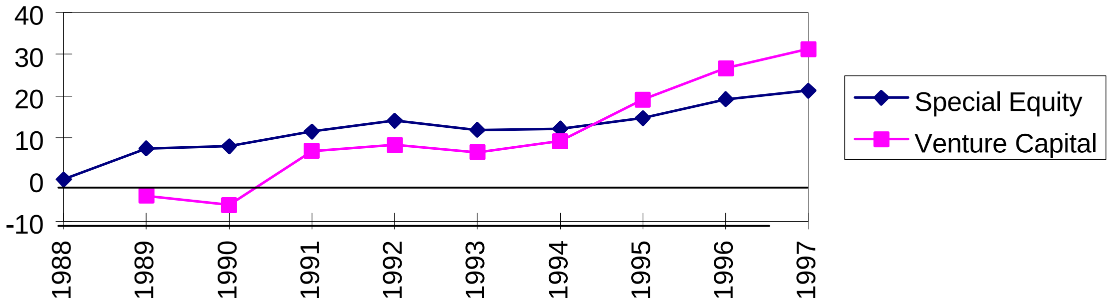
- Oil & gas: provides funding for the purchase or development of energy producing properties or companies operating within that sector.
- Global/International: partnerships that make later stage or LBO & MBO investments in companies based domestically or abroad.
- Privately placed debt: separate accounts or pooled funds which invest in investment grade and non-investment grade privately placed debt securities.
- Mezzanine: investments in unsecured or junior obligations in financing. Typically earn a current coupon or dividend and have warrants on common stocks or conversion features to enhance returns.
- Other non-venture capital investments.

OVERVIEW OF THE J-CURVE PHENOMENA

It is important to describe and understand the cash flow behavior of partnership investments as it relates to what is referred to as the "J-curve". The J-curve effect can be summarized as the first years' investment expenses of investing in a fund to harvest capital gain in the future. This normally translates into a negative IRR in the early years of the fund. The following graph illustrates the qualitative change over time of the internal rate of return of a hypothetical private equity program that is progressing normally, showing a typical J-curve, with the crossover from negative to positive returns generally expected between years three to five of the program:



The following graph traces the weighted average internal rate of return of STRS' partnerships since inception, and shows that positive performance appears on average after year two.



Source: Pathway Capital Management

MANAGING RISK

A disciplined approach in the investment process is a key element for managing risk. It is necessary to exercise top down judgment regarding the risk and return characteristics of each sub-class to reduce exposure to over-valued areas while increasing exposure to under-served market segments. Finally, it is important to select the highest quality investment managers in each market segment. Management teams should have unique competitive advantages and highly distinctive strategies.

INDUSTRY BENCHMARKS

There are many different indices used in the private equity investment area to measure performance. Some are relative measures, while others are absolute measures of performance.

Venture Economics is the best industry source of data, and is the most commonly used. It has assembled an extensive database of private equity partnership returns. The database includes over 588 venture capital partnerships formed since 1969, and over 215 special equity partnerships formed since 1976. Venture Economics collects cash flow and market data from each partnership and computes a net IRR to limited partners.

An overview of the most commonly used benchmarks is discussed below.

- **Relative-Peer Group Comparison-The Vintage Year Approach**

A performance measurement for private equity partnerships is an industry-wide, vintage year approach. The distinct advantage of this system is that it allows investors to compare performance of a given fund with all other funds started in the same year. This method categorizes partnerships into subgroups according to the year the partnership was initially funded, and calculates a cumulative annualized internal rate of return since inception on a pooled basis. The pooled IRR for each vintage year is then compared to the industry quartile rankings as provided by Venture Economics.

- **Relative-Comparison Across Asset Classes**

Benchmarking across asset classes is challenging since the methods for measuring performance in the private equity asset class are different from those employed in the more traditional asset classes. The primary difference is that private equity performance is measured using an internal rate of return while other asset classes employ time-weighted rates of return. In general, the private equity asset class is expected to outperform public equities, typically measured by the S&P 500 or the Russell 3000, by 400 to 600 basis points measured over rolling ten-year periods. The time frame of rolling ten-year periods is essential given the long term nature of private equity partnership investments and the time required for the investments to mature.

- **Absolute-Internal Rate of Return (IRR)**

The performance of a private equity partnership program is measured as an internal rate of return, cumulative since inception in accordance with standards promulgated by the Association for Investment Management and Research (AIMR). Cash outflows (draw downs by the partnerships) and cash inflows (distributions from the partnerships, valued on the date of distribution) are input as of the day they occur. On an interim basis, the general partner's valuation of the limited partner's interest is used as the residual value of the interest. Returns are calculated quarterly and are net of the management fees and carried interest paid to the general partners.

- **Absolute-Multiple of Money**

A "multiple of money" is often used to measure performance. This is a cumulative return, such as a tenfold return on investment over the term of the partnership. Achieving a high annualized rate of return over a long period of time is more impressive than achieving a high annualized rate of return for a short period of time.

RETURNS

Domestic Performance

Private market investments offer the opportunity to earn rates of return that are higher than public market alternatives, such as public equities and bonds. However, private market investments present higher risks which include the lack of liquidity, the long term holding of assets, and the lack of readily available markets to value private market investments. Investors participating in alternative investments must conduct a significant amount of due diligence and post investment monitoring to best evaluate and select alternative investments that will provide risk-adjusted rates of return.

Summary performance data provided by Venture Economics for private market partnerships in the following tables indicates that returns vary widely across and within vintage years, compared with the more efficient public markets where the difference between upper and lower quartile performance is generally much lower. This data implies that opportunities exist to improve returns by carefully selecting the best alternative investment managers.

Chart 1
Domestic Performance
Vintage Year IRR to Investors by Segment
as of September 1997

Special Equity*	1988	1989	1990	1991	1992	1993	1994**	Average
Upper Quartile	17.9%	20.7%	17.9%	23.4%	24.0%	25.5%	26.9%	22.3%
Median Quartile	12.2%	11.3%	16.2%	17.7%	19.9%	20.1%	20.5%	16.8%
Lower Quartile	10.7%	1.2%	5.2%	11.7%	8.8%	14.3%	0.1%	7.4%
Venture Capital								
Upper Quartile	22.3%	22.2%	39.6%	23.8%	41.5%	29.1%	38.2%	30.9%
Median Quartile	9.6%	11.0%	18.8%	13.8%	16.9%	13.1%	20.2%	14.7%
Lower Quartile	3.8%	3.2%	8.4%	1.4%	12.5%	6.8%	12.3%	6.9%
All Private Equity								
Upper Quartile	20.3%	21.6%	33.4%	23.8%	29.5%	27.0%	30.6%	26.6%
Median Quartile	11.7%	11.0%	17.0%	16.9%	18.6%	15.6%	20.2%	15.8%
Lower Quartile	3.9%	2.9%	6.4%	9.0%	12.5%	9.7%	10.1%	7.8%

Source: Venture Economics
*Special Equity is defined as buyout, mezzanine and other non-venture private equity funds
**IRRs for funds formed after 1994 are considered too young to be meaningful

International Returns

The preliminary results of the pan-European statistics from the 1997 International Investment Benchmarks Report were recently announced by Venture Economics. This independent study was carried out with the cooperation of the European Venture Capital Association (EVCA). The tables below display some of the results from this study.

European Private Equity
Cumulative Net IRRs from Inception to December 1996

Stage	Median Quartile	Upper Quartile	Pooled*
Early Stage Venture Capital	5%	13%	6%
Development Venture	5%	13%	7%
Buyouts	16%	25%	18%
All Private Equity	7%	17%	19%

Source: EVCJ
*Lower quartile returns are not available. "Pooled" is defined as a composite of all median and upper quartile funds returns.

European private equity demonstrated performance at 19% since inception on a pooled level. The IRR measure shows a wide range of varying results between stages with buyout at 18% and the special equity segment at 19%.

Index of European Private Equity (IRR Results)
Inception to December 1996

Stage	1YR	3YR	5YR	10YR
Early Stage Venture	48%	16%	13%	7%
Development Venture	19%	16%	10%	8%
Buyouts	33%	20%	17%	18%
Other Special Equity	24%	14%	14%	19%
All Private Equity	27%	14%	14%	19%

Source: EVCA

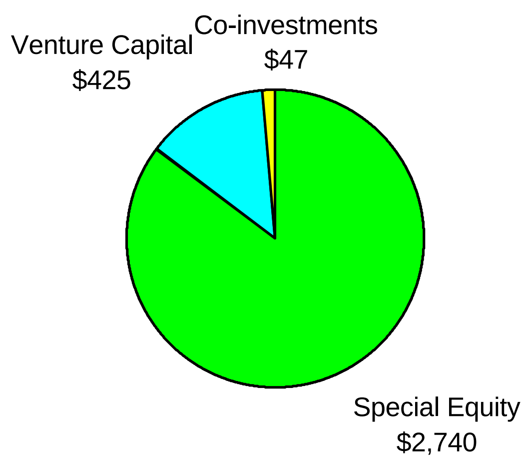
This index of private equity IRR results is a composite of 202 funds measured over a given time period (1980 to 1994). Only funds in existence both at the beginning of the horizon period and the end of the date are included in the data set.

On a one year basis, private equity funds posted a 27% net IRR to their investors for the year ending 1996, with early funds showing the highest performance (48%), followed by buyouts (33%). This indicates that recent performance has had an important impact on boosting longer term returns.

STRS' ALTERNATIVE INVESTMENT PORTFOLIO

STRS' alternative investment portfolio includes investments in primary and, to a much lesser extent, secondary interests in domestic and international investments. The first partnership investment was made in 1988. As shown below, STRS has committed $3.2 billion to 63 limited partnerships and two co-investments as of December 31, 1997. The limited partnership investments consist of 16 venture capital funds and 47 special equity funds.

Investment Strategy Diversification
for STRS Alternative Investment Portfolio



The Institute of Fiduciary Education (IFE) conducted a survey to measure strategic diversification within public pension plan alternative investment portfolios. The chart which follows shows the composition of STRS' portfolio as it compares to the portfolios in the peer group.

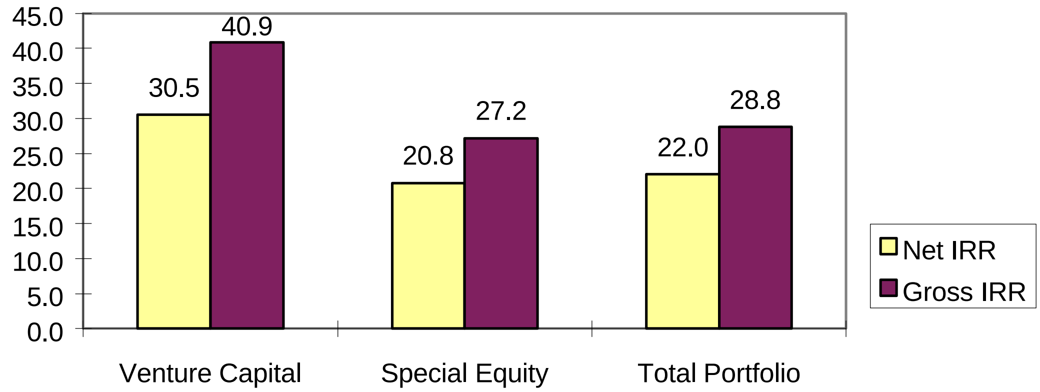
	STRS	Public Plans	Variance
Corporate Acquisition	61%	57%	+4%
Venture Capital	19%	20%	-1%
Subordinated Debt	8%	1%	+7%
International	4%	3%	+1%
Natural Resources	3%	3%	0%
Other	5%	16%	-11%

Source: IFE

Overall, STRS' portfolio closely resembles those of other public plans. The greatest variance occurs in the subordinated debt category. This is due to STRS' investments in several large buyout partnerships that establish both debt and equity pools of capital to facilitate investment purchases.

Portfolio Performance

The following graph illustrates the net and gross IRRs of STRS' venture capital and special equity partnership investments as of June 30, 1997.



Source: Pathway Capital Management

The portfolio consists of partnerships with an average age of less than 5 years. STRS' 22% return is above the average median return as calculated by Venture Economics for funds formed during 1988-1994. As previously indicated in Chart 1 in the analysis of domestic private equity, the average private equity performance by quartile was 7.8% for the lower quartile, 15.8% for the median quartile, and 26.6% for the upper quartile.

The following charts illustrate the performance of STRS' special equity and venture capital partnerships by generation relative to the Venture Economics benchmark. STRS' performance figures used below were calculated by Pathway Capital Management.

Special Equity:

STRS' Special Equity Partnership Performance
By Vintage Year
As of December 1997

Generation	# of Funds	$ Committed	STRS' Net Returns	V.E. Median Return	Variance from Median
1987	1	4.6 M	60%	10%	+50
1988	1	100	14%	12%	+ 2
1989	5	243	19%	11%	+ 8
1990	3	52	16%	16%	0
1991	2	25	18%	18%	0
1992	3	110	33%	20%	+13
1993	5	245	26%	20%	+ 6
1994	7	288	34%	21%	+13
1995	4	272	-4%	- 2%	- 2
1996	5	275	63%	-16%	+79

Most recent benchmark data is as of September 30, 1997

An analysis of the special equity portfolio aggregate by partnerships formed in the same vintage year shows that STRS' special equity partnerships have outperformed the median return of the Venture Economics benchmark in seven of ten years. STRS' vintage year funds established in 1990 and 1991 have tracked the median performance of the Venture Economics benchmark. The 1996 generation has outperformed the median Venture Economics benchmark by 79% due largely to the performance of the Thomas Lee Fund III with an early IRR of 132%.

Venture Capital:

STRS' Venture Capital Partnership Performance
By Vintage Year
As of December 1997

Generation	# of Funds	$ Committed	STRS' Net Returns	V.E. Median Returns	Variance
1989	1	10 M	13%	11%	+2
1990	1	25	32%	19%	+13
1992	3	45	40%	17%	+23
1993	3	125	34%	13%	+21
1994	1	60	13%	20%	-7
1995	2	40	49%	25%	+24
1996	2	80	3%	-0.4%	+3.4

Most recent benchmark data is as of June 1997.

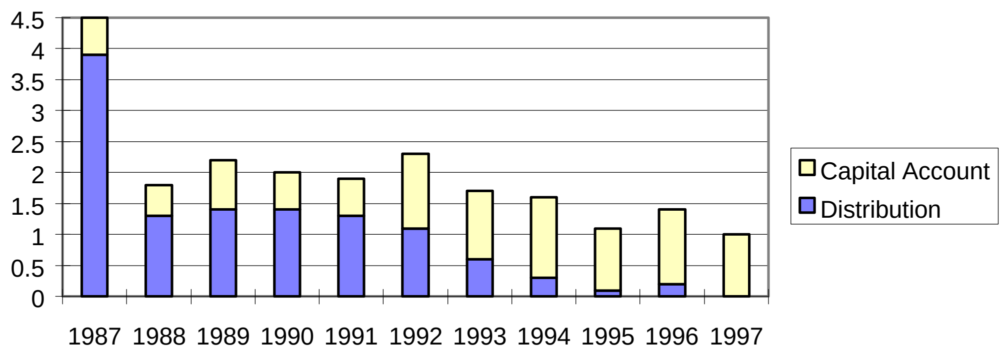
The vintage year breakdown of the venture capital portfolio indicates that the STRS' portfolio has outperformed the Venture Economics benchmark in six of seven years. The success of the 1995 generation can be attributed to the performance of Summit Ventures IV with an IRR of 61%. Alpine Technology Ventures, STRS' venture capital representative for vintage year 1994, is lagging the Venture Economics benchmark by 7 points.

OTHER MEASURES OF PERFORMANCE

Another indication of performance is the relationship between the value of each partnership and its contributed capital. The following graph illustrates the relationship between the value and contributed capital through the use of a multiple for each generation of funds in the portfolio. A multiple that is greater than one indicates that the generation's total value exceeds the amount of capital contributed to date, whereas a multiple of less than one indicates that the generation's total value is less than the amount of capital contributed.

The chart also indicates how much of the total value can be attributed to realized performance (distributions). When distributions equal 1.0x, the generation of funds will have returned all of its capital back to STRS and any additional distributions will result in gains to the partnerships. As shown below, for generations 1987 to 1992, STRS has been distributed all of its capital, and has additional unrealized value remaining in the partnerships.

Multiple of Total Value to Capital Contributed
as of December 1997



Source: Pathway Capital Management

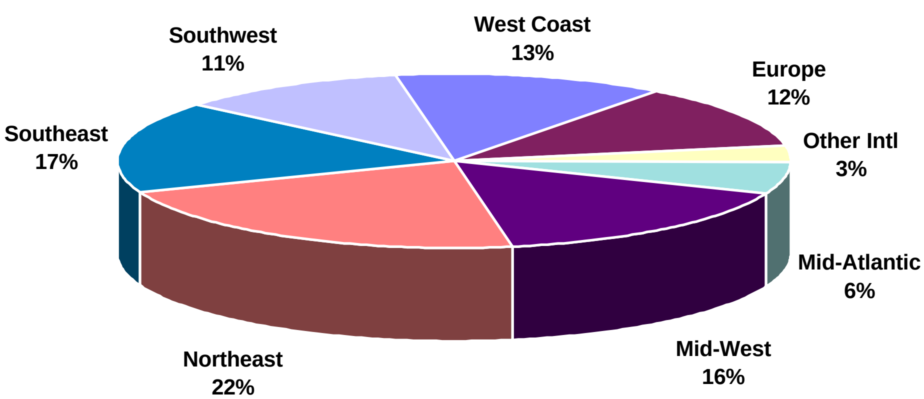
Portfolio Diversification

STRS' alternative investment portfolio is diversified by industry category and geographic exposure with more than 850 investments in different companies. The following charts show the current composition of STRS portfolio. This analysis shows that medical, computers, communications and consumer industries make up 67% of STRS' portfolio. The first three industries are considered to be high growth, expanding sectors and by design are an important part of the portfolio.

The portfolio is also diversified by geographic region. The largest concentration of investments are located in the northeastern United States (22%) and the southeastern United States (17%).

STRS Portfolio Diversification by Industry
December 1997

STRS Portfolio Diversification
by Geographic Region
December 1997



Source: Pathway Capital Management

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MERCER STUDY 1996 - Key terms and conditions for private equity investing

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Please note: Attachment 2 is not available in electronic format at this time.

INTRODUCTION

In accordance with the Investment Management Plan, California State Teachers' Retirement System (STRS) has a commitment to illiquid equity and equity related funds actively managed by specialized professionals to achieve a total rate of return superior to public equity vehicles.

The portfolio holding these assets is identified as Alternative Investments. This portfolio can include limited partnerships, direct investments, co-investments, and secondary interests in the following market segments:

Leveraged Buyout
Venture Capital
Distressed Debt
Mezzanine Financing
Hedge Funds
Natural Resources

The primary objective for the alternative investment portfolio is to provide enhanced investment returns over those available in the public market. The increased risk associated with the structure, liquidity, and leverage require a higher net total rate of return.

The STRS' Board established the asset allocation and strategic objectives for the alternative investment portfolio. The management of all types of investments are performed by internal and external professionals which are monitored and evaluated by internal investment officers and an external alternative investment advisor. The internal investment officers operate under the direction of the Chief Investment Officer or designee. The external alternative investment advisor reports directly to the STRS' Board.

This manual will establish the policies and procedures involved in managing alternative investments. The policies are designed to provide guidelines for the implementation of the approved policies. A flow chart is provided to establish context for the policies and procedures presented.

ALTERNATIVE INVESTMENT
PORTFOLIO POLICIES

The following represent the approved policies to be utilized in the management of the alternative investment segment of the total investment portfolio. The policies are designed to set boundaries for the expected performance and structure. Policies approved by the STRS' Board cannot be altered without explicit direction from the STRS' Board.

1. The alternative investment portfolio of the California State Teachers' Retirement System is invested in a prudent manner for the sole benefit of STRS' participants and beneficiaries in accordance with the Teachers' Retirement Law and other applicable statutes.

2. The alternative investment portfolio should be invested to provide enhanced investment returns. Generating high rates of return should always be the primary objective with diversification being an ancillary benefit.

3. Diversification within the alternative investment portfolio is critical to control risk and maximize returns. The specific investments should be aggregated, evaluated, and monitored to control unintended biases. Diversification can occur across the following parameters.

   A. **Market Segment** -- The market segments are defined as Leveraged Buyout, Venture Capital, Distressed Debt, Mezzanine Financing, Hedge Funds, and Natural Resources.

   B. **Vintage Group** -- Vintage group is defined by the closing of the limited partnership. Investments within market segments should be stratified by vintage group to mitigate the impact of fund flow trends within each segment.

   C. **Economic Sector** -- Economic sectors are depicted by the standard Value-Line categories such as finance, technology, medical health, or electronic.

   D. **Geographic Location** -- Geographic regions are defined as the location of the head office of the company. The geographic breakdown is expressed as West Coast, Southwest/Rockies, Southeast, Northeast, Mid-West, Mid-Atlantic, United Kingdom, Europe, Canada, and Other International.

4. A strategic target and range shall be established for the market segment and geographic diversification criteria. The target and range may change over time as conditions warrant as approved by the Investment Committee. The target and range criteria are included as Exhibit 1. The diversification criteria will be reviewed on an annual basis.

5. Investments shall not be approved for the sole purpose of aligning one specific diversification range. Projected rate of return, risk, and other policies should receive consideration in addition to diversification.

6. No investment vehicle or activity prohibited by the Investment Resolution adopted by the Board in 1984, as amended from time to time, will be authorized for the alternative investment portfolio.

7. Authorization letters which indicate who may sign on behalf of STRS shall be included at the time of closing. Whenever a change in authorized signers take place, the limited partnerships shall be notified in writing within 24 hours in the event of termination and as soon as possible in the event of a newly authorized signer(s).

8. Prior to being processed by the Operations Area, all cash contribution and stock sales transactions tickets shall be signed by two Investment Officers.

9. Graduated limitations of daily trading authority for aggregate alternative investment portfolio transactions are as follows:

Associate Investment Officer	$ 1 million
Investment Officer I	$ 5 million
Investment Officer II	$ 10 million
Investment Officer III	$ 20 million
Director of Alternative Investments	$ 50 million
Chief Investment Officer	$200 million

10. The rejection decision for limited partnerships, direct investments, co-investments, and secondary interests is delegated to staff with the stipulation that all limited partnerships receive equal opportunity and subject to the appropriate amount of due diligence as defined in the alternative investment procedures.

11. The approval decision for “follow-on” limited partnerships is delegated to staff considering the following stipulations:

   A. Applicable only to limited partnerships sponsored by general partner(s) included in the STRS' alternative investment portfolio.
   B. Due diligence process shall be consistent and appropriate as defined in the alternative investment procedures.
   C. Maximum amount of the commitment should not exceed $400 million or 20% of the total amount of the partnership capitalization, whichever is less.
   D. A final report will be presented to the Investment Committee as soon as practical after the commitment is completed.

12. The approval decision for “new” limited partnerships is delegated to staff considering the following stipulations:

   A. Due diligence process shall be consistent and appropriate as defined in the alternative investment procedures.
   B. Maximum amount of the commitment should not exceed $100 million or 20% of the total amount of the partnership capitalization, whichever is less.
   C. A final report will be presented to the Investment Committee as soon as practical after the commitment is completed.

13. The approval decision for co-investments is delegated to staff considering the following stipulations:

   A. Co-investments shall be made on the same (or better) terms and conditions as provided to the partnership.
   B. Due diligence process shall be consistent and appropriate as defined in the alternative investment procedures.
   C. Maximum amount of the commitment should not exceed $50 million or 30% of the STRS' commitment to that partnership, whichever is less.
   D. A final report will be presented to the Investment Committee as soon as practical after the commitment is completed.

14. The approval decision for secondary limited partnership interests is delegated to staff considering the following stipulations:

A. Due diligence process shall be consistent and appropriate as defined in the alternative investment procedures.

B. Maximum amount of the commitment should not exceed $50 million or 20% of the total amount of the partnership capitalization, whichever is less.

C. A final report will be presented to the Investment Committee as soon as practical after the commitment is completed.

15. Distributions received in the form of stock shall be managed as identified in the alternative investment procedures. All sales will be subject to the trading limitations shown in the internal equity policy and procedure manual.

ALTERNATIVE INVESTMENT
PORTFOLIO PROCEDURES

The Board adopted the Investment Management Plan, which was originally drafted in 1986, and has been periodically updated to reflect the changes that have occurred in the investment strategy and policy. The Investment Management Plan mandates the investment of plan assets in four broad categories: public equity, public debt, private equity, and private debt.

1. **STRS' Board** -- Approves the size and scope of the alternative investment program and establishes the asset allocation target and range. Directs the Chief Investment Officer (CIO) to periodically report on the compliance with established polices and procedures.

2. **Chief Investment Officer** -- Establishes the program guidelines in such areas as (1) evaluating limited partnerships, (2) declining or approving of limited partnerships (within the amounts delegated by the Board), (3) establishing targets and ranges for diversification purposes as shown in Exhibit 1, and (4) controlling the stock sales program.

3. **Investment Officer** -- The alternative investment unit receives and reviews offering memoranda from a variety of sources. The offering memoranda provide an overview of the investment philosophy, strategy, and terms and conditions of the proposed limited partnerships. After the investment officer(s) review and analyze the principal terms and conditions of the proposed limited partnership and major accomplishments of the management group, all of the pertinent data is entered into a database.

4. **Investment Officer** -- After analyzing the offering memoranda, if there is sufficient interest and compatibility, the investment officer may arrange a meeting with the general partners to discuss the proposed limited partnership. Subsequent to this meeting, the investment officer(s) will evaluate the merits of the proposed limited partnership's investment strategy, terms and conditions, management's qualifications, and previous track record. A ranking is assigned between one to ten, with one being the lowest and ten the highest.

5. **Investment Officer and/or Advisor --** Under the supervision of the Director of Alternative Investments, the staff and/or advisor may be

asked to conduct due diligence in accordance with but not limited to the following aspects:

A. Experience working together as a team
B. Identifiable track record
C. Special skills or industry expertise
D. Size of proposed fund in comparison to previous experience
E. Well defined and realistic investment strategies
F. Ability to realize gains with successful exit strategies
G. Ability to add value through revitalizations, acquisitions, or other strategies

6. **Investment Committee or Chief Investment Officer** -- After completion of the due diligence process, the limited partnership commitment will be approved or declined within delegation amounts listed in sections 11 thru 14 of the alternative investment policy section.

7. **Director of Alternative Investments** -- After approval of a commitment to an investment, STRS will analyze the terms and conditions of the limited partnership. Any terms which are identified as potentially unfavorable or inconsistent with STRS' goals and objectives are then discussed and negotiated with the general partners of the proposed limited partnership. The STRS may decline participation in an investment if terms considered to be "deal breakers" cannot be resolved in a satisfactory manner.

8. **Director of Alternative Investments and STRS Legal Counsel** -- While negotiating terms and conditions of the legal limited partnership agreement documents, STRS' legal counsel will be appraised of the negotiation progress periodically. When the documents are acceptable to the interested parties, the alternative investment advisor and STRS' legal counsel will issue written documentation. If any of the terms are identified as unacceptable or objectionable, then STRS or the advisor will enter into additional negotiations with the general partners. When all terms have been finalized and approved by all parties, the documents are forwarded to the Chief Investment Officer for review and signature.

9. **Director of Alternative Investments** -- The Director of Alternative Investments or designee will attend advisory board meetings in which STRS holds an advisory board seat. Attending the meetings will allow STRS to monitor its interest and enhance the value of information reporting with the general partner. Attendance at all meetings will be coordinated with the advisor.

10. Investment Officer -- STRS' limited partnership investments periodically request cash contributions (capital call) from the limited partners. The investment officer receives notice of a capital call on the limited partnership letterhead with an authorized signature. Capital call notices include details on the amount of cash requested, date of transfer, purpose of call, and wiring instructions.

The capital call notices are very closely scrutinized by the investment officers. The notices are inspected to make certain they include the appropriate signatures and contain all of the information necessary to effect the wire transfer. Any discrepancies identified must be satisfactorily explained prior to processing each capital call notice.

11. Investment Officer -- After confirmation of the capital calls amount due, date of transfer, and wire instructions. A purchase transaction form (Exhibit 2) is then completed and signed. The purchase transaction form plus a copy of the capital call notice is forwarded to the operations unit for processing. The purpose of the purchase transaction form is two-fold: 1) to notify the custodian to schedule payment of the capital call; and 2) to notify the cash management function in the Operations Unit to consider the contribution in the cash forecast.

12. Investment Officer -- STRS receives periodic cash distributions as a result of its participation in the limited partnership investments. Notices of cash distributions are sent on the partnership letterhead and contain information regarding date of distribution, amount of distribution, components of the distribution including return of cost, gain, interest and dividends, and a description of the source of the distribution. The investment officer reviews the distribution notice and prepares a cash distribution form (Exhibit 3) to the master custodian. The purpose of the cash distribution form is two-fold: 1) to notify the custodian to expect receipt of the funds, including proper accounting treatment; and 2) to notify the cash management function in the Operations Unit to consider the distribution in the cash forecast.

13. Investment Officer -- STRS receives periodic stock distributions as a result of its participation in the limited partnership investments. The stock distribution notices should identify the name of the partnership making the distribution, the name of the stock, number of shares distributed, the closing price of the stock on the distribution date, a cost basis per share, and the name of the broker (if any) handling the stock distribution. The investment officer prepares a stock distribution form (Exhibit 4) notifying the master custodian of the stock distribution. The stock distribution form identifies the partnership making the distribution, name of stock, number of shares, fund number, trade date, settle date, stock cusip, price per share, total cost, and method of delivery.

14. **Investment Staff** -- A cash database which should be updated, at least monthly, to reflect all cash contributions and distributions, stock distributions, and stock sales activity for each limited partnership. The investment staff performs a monthly reconciliation with the master custodian and advisor to verify that all transactions are accurately recorded. The reconciliation is analyzed with all discrepancies discussed and corrected.

15. **Investment Staff** -- The fund performance worksheet (Exhibit 5) shall be completed on a quarterly basis. The data contained in the worksheet provides specific performance measurements including: net gain/loss in funds, total return ratio, distribution return ratio, and annual IRR.

16. **Investment Staff** -- A market pricing report (Exhibit 6) should be completed and forwarded to the master custodian on a quarterly basis. This report contains information that allows the investments made by the limited partnerships to be carried at a market valuation rather than strictly a cost basis.

17. **Investment Officer** -- The limited partnerships' performance and portfolio are closely monitored. Part of the monitoring process includes discussions with the general partners at least annually either in person or via telephone. These discussions enable the investment officer the opportunity to effectively evaluate performance, investment strategy, and to interact one-on-one with the general partners. Additional reports will be provided as requested by the Chief Investment Officer, Teachers' Retirement Board, or Internal Audit Department.